



Global Credit Research
 Rating Update
 4 AUG 2003

Rating Update: **California (State of)**

MOODY'S DOWNGRADES CALIFORNIA'S GENERAL OBLIGATION BONDS TO A3 FROM A2, LOWERS LEASE-BACKED DEBT TO Baa1 FROM A3. RATINGS TO REMAIN ON WATCHLIST FOR POSSIBLE FURTHER DOWNGRADE.

Approx. \$34 Billion in Debt Affected

State
 CA

Opinion

NEW YORK, Aug 4, 2003 – Moody's Investors Service lowered the rating on the State of California's general obligation bonds to A3 from A2, and lowered the rating on the state's lease revenue bonds to Baa1 from A3. The ratings remain on Watchlist for possible further downgrade. Approximately \$29 billion of general obligations and \$5 billion of lease bonds are currently outstanding and affected by these actions.

The downgrade reflects the continued large size of the state's structural budget gap, following recent adoption of the fiscal 2004 budget, and Moody's view that the state will have substantial difficulty closing this gap in the next budget cycle. As a result, the agency anticipates that the state's recent pattern of late budgets, reliance on sizable short-term borrowings, and use of spending deferrals and other non-recurring resources, including deficit bonds, will continue through at least fiscal 2005.

In the recently concluded budget for fiscal 2004, the state has accommodated its near-term spending and cash needs through the assumed issuance of \$14.5 billion of long-term deficit funding bonds, and reliance on at least \$6 billion of additional one-time federal revenues, accounting changes, spending deferrals, and other non-recurring items. However, the budget also makes a number of recurring structural improvements, including a \$4 billion increase in the motor vehicle license fee and cuts in spending programs. The budget also anticipates a positive ending cash balance after repayment of all short-term debt in June 2004.

Nonetheless, the state estimates a fiscal 2005 budget gap of \$8 billion, or roughly 10% of projected General Fund spending for the year. Given the usual forecast risks associated with the state's fiscal plan – including the pace of economic and stock market recovery, and the ability to realize anticipated cost savings in various state programs during the year – the gap could grow to exceed \$10 billion. Moody's believes a continued gap of this magnitude will present a formidable budget challenge next year. In light of the constitutional requirement for a two-thirds majority vote, and the legislature's inability to agree for the past two years on whether to enact deep spending cuts or significant tax increases, the state's finances could remain pressured for several more years.

In addition, while the state's intention to retire its short-term debt by effectively refunding it with long-term deficit bonds is viewed as a constructive funding strategy, the bonding plan also exposes the state to potentially significant execution risks. These include the risks of bond sale delay due to anticipated litigation regarding its constitutionality, and general market access risk. With at least \$11 billion of short-term debt maturing in June 2004, the state's cash and liquidity position could be compromised should it not be able to complete its planned long-term financings before the end of the fiscal year. Therefore, pending further analysis of the execution risks in the plan, Moody's is maintaining the state's long-term ratings on Watchlist for possible further downgrade.

Moody's anticipates that more information will be presented by the state regarding the long-term deficit bond financings in connection with its plan to sell additional short-term notes this September. Repayment of these notes, similar to existing short-term debt, would be dependent on successful sale of the long term bonds. In the event that the general obligation rating were to be lowered below the A category, Moody's would likely conduct a review of the MIG-1 rating currently assigned to the state's outstanding revenue anticipation warrants (RAWs) scheduled to mature on June 16, 2004.

Finally, Moody's said that it recognizes that the state has never failed to meet its debt obligations, and the current A3 general obligation bond rating reflects the agency's opinion of the very low probability of a state

payment default. If it were to occur, however, any payment default would lead to a lowering of the state's long-term bond rating to a high speculative grade level. This reflects the view that the strong legal promise on the state's general obligation bonds and RAWs, together with its vast economic base, would likely result in full recovery of principal and interest for investors, thereby averting a downgrade to the lower speculative grade rating categories that are categorized by less than complete recovery.

The downgrade and Watchlist actions affect the following outstanding state long-term debt obligations:

- State of California General Obligation bonds (A2 to A3)
- California State Public Works Board lease appropriation bonds (A3 to Baa1)
- Los Angeles State Building Authority lease debt (A3 to Baa1)
- Oakland State Building Authority lease debt (A3 to Baa1)
- Riverside County Public Finance Authority lease debt (A3 to Baa1)
- San Bernardino Joint Powers Financing Authority lease debt (A3 to Baa1)
- San Francisco State Building Authority lease debt (A3 to Baa1)
- California DOT (East Bay State Building Authority) COPs (A3 to Baa1)
- Sacramento City Financing Authority (Cal EPA Building) lease debt (A3 to Baa1)
- Taft Public Financing Authority (A2 to A3)
- Shafter Joint Powers Financing Authority (A2 to A3)

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